Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
September 2019

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Investment outlook

‘Borisnomics’ could mitigate a Brexit bust

Since entering No. 10, Boris Johnson’s political strategy on Brexit has been to take a hard line stance with the EU. At the very least, the Prime Minister (PM) appears to be hoping that by threatening ‘no deal’ — and circumventing parliament — the EU will renegotiate the backstop on the Irish border.

Regardless of how the politics shapes up in the autumn, we expect the new government to crack on with policies to mitigate the economic risk of a no deal Brexit. We see four key areas where this so-called ‘Borisnomics’ could ease investors’ fears from leaving the EU without a withdrawal agreement.

Fiscal policy

At the heart of the Johnson administration’s Brexit toolkit will be a rolling back of austerity to lift economic growth over the medium term. Based on data from the Institute of Fiscal Studies and the PM’s announcements, we find that the government’s fiscal stimulus plans - income tax and national insurance contributions cuts, plus more expenditure on education, NHS and the police — could increase by over GBP30bn (1.4% of GDP) cumulatively by 2023/24.

Taking into account this fiscal stimulus, the government is at risk of breaking the 2% structural (i.e. non-cyclical) budget deficit target rule established under the Charter for Budget Responsibility in 2010. However, the new Chancellor, Sajid Javid, could modify current fiscal rules to give the government more spending and tax cutting headroom.

For example, were the government to scrap its structural budget deficit target and change the fiscal charter simultaneously to keep public debt to GDP constant, we estimate it could free up around £233bn GBP (9% of GDP) in cash over the next four years. While such a large increase in state spending is probably unlikely under the Tories, there is the potential for the government to widen the deficit over the fiscal horizon should the impact of a no deal Brexit weigh on the economy.

Monetary easing

Expect a loosening in monetary policy. While the Bank of England (BOE) sets UK policy interest rates independently, the Johnson administration will have a say on who will replace BOE governor Mark Carney when his term ends in January 2020. It is possible that a more dovish BOE governor is selected to fit in with ‘Borisnomics’ and that this appointment could steer: i) the Monetary Policy Committee to lower interest rates; ii) a new Quantitative Easing program by expanding the BOE’s balance sheet; iii) the BOE’s mandate to revise-up the current 2% inflation goal. Such measures would allow for a more flexible approach in using monetary policy to navigate the business cycle in a post-Brexit world.

Deregulation

The government could adopt deregulation as part of its economic policy. In the past, Boris Johnson has talked about a divergence in UK rules from the EU in particular sectors to raise productivity and exploit new technologies. As a template, President Trump’s supply-side reforms of US deregulation to cut bureaucratic red tape, as well as tax cuts, led to a surge in small business confidence and accelerating productivity growth.

The housing market

Simplifying or reducing stamp duty could boost the housing market, an issue that has been favoured by Mr Johnson during his Tory leadership campaign. Considering the fairly strong relationship between house prices and private consumption growth, reducing property transaction costs could lead to a pick-up in housing market activity and provide significant lift to overall economic growth.

We believe that ‘Borisnomics’ could mitigate some of the apparent risks surrounding a no deal Brexit. Given undemanding valuations and the rise of the Tories in opinion polls that reduces the risk of a left-wing Jeremy Corbyn Labour government, UK equities are starting to look more attractive.

Incorporating trade sentiment in markets

The backdrop for world trade worsened in August. Although President Trump has pushed back part of the additional 10% tariff on $300bn of Chinese exports, Japan and South Korea have engaged in their own trade feud. The two countries removed each other from the list of trusted trading partners.

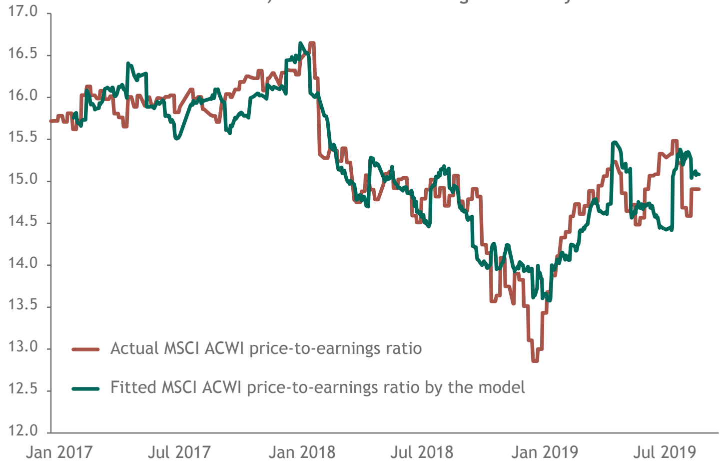
Motivated by the work of the Bank of England, we constructed a world trade sentiment index to help gauge how much of worsening trade sentiment is priced in by the market. When we take into account improving fundamentals (proxied by earnings revisions) and the support from central bank (proxied by lower global bond yields), we find that the market has fully priced in the sentiment around trade (see chart on equities section). We believe this is a good investment framework to analyse what can be predicted (e.g. interest rates and company earnings) and what can’t (President Trump’s Twitter comments on trade).

In short, we find that the earnings improvement and easy monetary policy from central banks have offset worsening trade sentiment.

Equities

We incorporate global earnings revisions, our trade sentiment index and global government bond yields in a statistical model to predict the price-to-earnings ratio of the MSCI All-Country World Index. We then compare the predicted and actual numbers to see how the market is valued. At the moment, those numbers are 15.1x and 14.9x, respectively, which suggests the market is fairly priced. In other words, improving earnings outlook and support by global central banks have so far offset worsening trade sentiment.

MSCI All Country World Index (ACWI) valuation modelling, using earnings revisions, trade sentiment and global bond yields

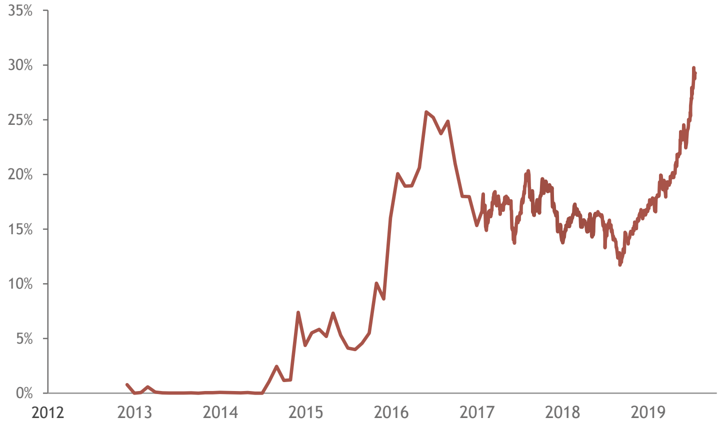


Source: Media outlet, Datastream/Smith & Williamson, Data as at 30 August 2019

Fixed income

The broad macro drivers of lower government bond yields are largely intact. These include: i) rising public debt that borrows from future growth, ii) deteriorating demographics in countries (e.g. Japan) that lowers domestic demand; iii) ongoing central bank purchases of bonds. Macro drivers continue to push bond yields down and increase the share of negative yielding debt, the bulk of which is in Eurozone and Japanese fixed income markets.

Total value of negative yielding global debt, as % of total bond outstanding

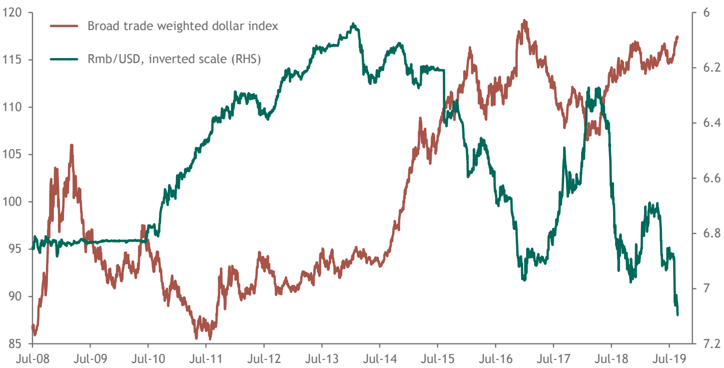


Source: Bloomberg/Smith & Williamson, Data as at 30 August 2019

FX

Given rising Sino-US political tensions, the Chinese currency (the renminbi) fell to an 11-year low against the US exchange rate and by nearly 4% in August, the biggest depreciation for nearly 25 years. Amid an escalating trade war it does seem that the Chinese authorities have allowed their currency to weaken, perhaps to use it as a 'weapon' against President Trump's trade protectionist agenda. The USD has been the key beneficiary of the uncertainty created by trade protectionism, pushing the trade-weighted USD index close to record highs.

US dollar broad trade-weighted index and Rmb vs USD FX rate



Source: Thomson Reuters Datastream/Smith & Williamson, Data as at 30 August 2019

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-1.8	8.1	7.0	83.2
FTSE 100	-4.1	2.0	1.5	29.2
FTSE 250	-1.1	3.1	-3.4	40.0
S&P 500	-1.1	10.6	9.8	120.8
MSCI Europe ex UK	-1.2	7.1	5.2	57.6
MSCI Japan	-0.5	6.5	1.1	73.8
MSCI Pacific ex Japan	-5.2	3.0	7.9	50.5
MSCI Emerging Markets	-4.3	3.5	2.5	41.6
Bonds				
iBoxx GBP Gilts	3.8	6.2	11.8	34.3
iBoxx USD Treasuries	4.0	8.4	18.0	59.0
iBoxx GBP Corporate	1.4	5.3	9.9	33.2
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-6.5	-6.9	-22.1	-40.4
Gold ($/ounce)	7.1	17.6	27.1	18.7
GBP/USD	-0.5	-3.4	-6.3	-26.7
GBP/EUR	0.6	-2.2	-1.0	-12.3
EUR/USD	-1.1	-1.2	-5.4	-16.4
USD/JPY	-2.2	-2.2	-4.3	2.2

Glossary of terms

Bonds – The relationship between price and yield. Yield is the return you get on a bond. When the price of a bond changes prior to maturity due to supply and demand pressures, so does its yield. When the price of a bond goes up due to demand, the yield goes down to compensate. This is so the bond's fixed rate of return (coupon) remains relatively constant – and vice versa. A bond's price and its yield are inversely related. A key factor which influences a bond is the prevailing interest rate. When interest rates rise, the prices of bonds fall, thereby raising yields. This is because the older bonds are sold in order to buy new higher yielding bonds.

Equities – A stock or any other security representing an ownership interest.

GDP – Gross Domestic Product.

Monetary policy – Actions of a central bank or other agencies that determine the size and rate of growth of the money supply which will affect interest rates.

Key macro data	Latest	2019 Consensus forecast	Spot rates	31-Aug	Yields (%)	31-Aug
UK GDP (YoY%)	1.2	1.25	GBP/USD	1.22	FTSE 100	4.54
UK CPI Inflation (YoY%)	2.1	1.90	GBP/EUR	1.11	FTSE 250	3.23
Bank of England Base	0.75	0.75	EUR/USD	1.10	10 Year Gilt	0.40

All values and charts as at 31 August 2019. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Thomson Reuters Datastream and Bloomberg

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

For further information

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